REPORT OF EXAMINATION
OF THE

CALIFORNIA INSURANCE
GUARANTEE ASSOCIATION

AS OF
JUNE 30, 2005

Filed August 21, 2006

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Los Angeles, California
May 1, 2006

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

CALIFORNIA INSURANCE GUARANTEE ASSOCIATION

(hereinafter also referred to as the Association or CIGA) at the primary location of its books and records, 700 North Brand Boulevard, Suite 1400, Glendale, California 91203.

SCOPE OF EXAMINATION

This examination covers the period from December 31, 2000 through June 30, 2005. The examination included a review of the Association's practices and procedures, an examination of management records, tests and analyses of detailed transactions, and an evaluation of the assets and a determination of liabilities as of June 30, 2005, as deemed necessary under the circumstances. The examination also included a review and analysis of the Association's cash flows through 2009.

In addition to those items specifically commented upon in this report, other phases of the Association's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers' and employees' welfare and pension plans; growth of company; and loss experience.

SUMMARY OF SIGNIFICANT FINDINGS

Fund Balance and Surplus Funds

As indicated in the following schedule, the Association's workers' compensation fund balance as of June 30, 2005 was a deficit of $3.5 billion (estimated $3.5 billion excess of liabilities over assets in this category). In total, for all categories of business, the fund deficit reported by the Association was $3.1 billion.

Category of Business	Fund Balance (deficit) as of June 30, 2005
Automobile and Homeowners	$ 243,787,706
All Other	188,924,538
Workers' Compensation	(3,519,427,259)
Subtotals - Fund Balance (Deficit)	$ (3,086,715,015)
Accumulated other comprehensive loss	(2,965,606)
Totals – Surplus Funds	$ (3,089,680,621)

The significant deficit as of June 30, 2005 was the result of several large insurance company insolvencies. The workers' compensation deficits for the largest insolvencies as of June 30, 2005 were as follows:

Workers' Compensation Insolvencies	Fund deficit as of June 30, 2005
Superior National Group	$ 1,772,696,213
HIH & Great States Insurance Companies	$ 390,788,996
Credit General Group	$ 109,296,441
Reliance Insurance Company	$ 324,688,472
Paula Insurance Company	$ 163,508,729
Legion and Villanova	$ 681,903,869
Fremont Indemnity Company	$ 1,763,085,133

Cash Flow Projections

At December 31, 2005, the Association had the ability to assess a maximum of a two-percent surcharge on California workers' compensation insurers' written premium. The two-percent surcharge is effective through December 31, 2007, and thereafter the surcharge is one-percent.

On September 30, 2003 the Governor of the State of California signed Assembly Bill 227 (AB227). AB227 enables the Association to issue up to $1.5 billion in bonds through the California Infrastructure and Economic Development Bank. The proceeds of these bonds will be used to pay and discharge workers' compensation claims.

On August 18, 2004, the Association issued $400 million in fixed rate and $350 million in variable rate Workers' Compensation Relief Bonds at a net premium of $32.8 million. Net proceeds from the issuance of the bonds after deducting underwriting discounts and insurance premiums were approximately $774.8 million.

The Association prepared a five-year cash flow projection (July 2004 through June 2009) which indicates that the Association has adequate funds to pay claims assuming that it receives proceeds from the issuance of additional bonds during 2006. The cash flow analysis does not anticipate the addition of new insolvencies or any additional payments from liquidators. Although the Association's outside actuary performed a limited analysis of the Association's cash flow projections and concluded that the cash flow projections were reasonable, a full actuarial analysis was not performed. According to the Association, the outside actuary's review of the cash flow projections was undertaken for the very limited scope of determining the adequacy of funds available to pay workers' compensation claims and the potential need for additional borrowing activity. It is recommended that the Association obtain a full and comprehensive actuarial analysis for the purpose of estimating future workers' compensation claims payments in the preparation of its cash flow analysis.

A comparison of actual claim payments from the Association's general ledgers for the fourth quarter of 2005 to the cash flow projection worksheets indicated that the Association's projections are reasonable (actual claim payments were slightly lower than projected) for that limited review period.

ASSOCIATION HISTORY

The Association was created by California legislation in 1969 to establish a fund from which insureds could obtain financial and legal assistance in the event their insurers became insolvent. The Association was organized pursuant to, and operates in accordance with California Insurance Code (CIC), Division 1, Part 2, Article 14.2, Section 1063. In addition, the Association functions pursuant to a Plan of Operation approved by the California Department of Insurance. The purpose of the Association is to provide insurance against losses arising from the failure of an insolvent insurer to discharge its obligations under its insurance policies. The Association is a statutory entity that depends on the Guarantee Act for its existence and for a definition of the scope of its powers, duties and protections. The Association issues no policies, collects no premiums, makes no profits, and assumes no contractual obligations to the insureds.

MANAGEMENT AND CONTROL

The Association is managed by a board of governors (board), composed of nine member insurers, each of which is appointed by the California Insurance Commissioner (Commissioner). At least five members of the board must be domestic insurers. At least three such members must be stock insurers, and at least three must be non-stock insurers. The nine members must be representative, as nearly as possible, of the classes of insurance and of the kinds of insurers covered by California Insurance Code Section 1063.9. In case of a vacancy on the board, the Commissioner shall appoint a member insurer to fill the unexpired term.

In addition to the nine member insurers, the membership shall also include one public member appointed by the President pro Tempore of the Senate, one public member appointed by the Speaker of the Assembly, one business member appointed by the Commissioner, and one labor member appointed by the Commissioner.

A listing of the members of the board and principal officers serving on June 30, 2005 follows:

Governors

Name	Principal Business Affiliation
John Boyle	Interinsurance Exchange of the Automobile Club of Southern California
Robert Chick	Lawyers' Mutual Insurance Company
Delia Chilgren	Allstate Insurance Company
Wayne Wilson	Mid-Century Insurance Company
James Tudor	State Compensation Insurance Fund
Linda Smith	Preferred Employers Insurance Company
Kathleen Dubia	Chubb Insurance Companies
Debbie Michel	Liberty Mutual Insurance Company
James Sevey	California Casualty Company
Shane Gusman	Attorney, Barry Broad Associates- Labor appointment
Scott Hauge	Insurance Broker – President pro Tem appointment

The business member and the appointment by the Speaker of the Assembly were both vacant.

Principal Officers

Name	Title
Lawrence E. Mulryan	Executive Director
Phillip C. Cochran	Director of Claims
Richard L. Hurd	Director of Finance

Conflict of Interest

The Association does not require its management or employees to complete annual conflict of interest statements. The Association instead incorporates its conflict of interest policy within the employee handbook, which is provided to an employee initially and intermittently thereafter (whenever major revisions of the handbook are made). The most recent major revision of the handbook was July 2000. The Association deems the conflict of interest disclosures to be fulfilled by the receipt of the handbook and evident non-response by each employee. Although it was recommended in the prior examination report that the Association provide written conflict of interest disclosure forms to be signed by its employees on an annual basis rather than the more informal approach currently utilized, the Association has not made any changes to its procedures. It is again recommended that the Association provide written conflict of interest disclosure forms to be signed by employees on an annual basis. In response to this recommendation, the Association will (beginning in 2006) provide written conflict of interest agreements to be signed by management staff on an annual basis.

Third Party Administrators

The Association has agreements with various third-party administrators (TPAs) to primarily administer workers' compensation claims of insolvent companies until those claims are closed. The agreements have a cancellation provision whereby the Association can cancel the agreements with the TPAs by providing 30 days or, in some cases, 60 days written notice. Fees to the TPAs are paid based on the number of claims filed and are paid at the inception of the agreements except for Broadspire (formerly known as Kemper Employers Claims Services and NATLSCO, Inc.) which is paid in installments. The TPAs have the authority to issue claim payments up to $25,000. Claim payments in excess of $25,000 require the approval of the Association's management.

The claims administered by these TPAs as of June 30, 2005 comprise a material amount of the outstanding claims of the Association. The following is a summary of the TPAs currently utilized by the Association:

Third Party Administrator	Effective Date	Line of Business	Insurance Company
NATLSCO, Inc. now Broadspire	8/24/00	Workers' Compensation	Superior, Cal Compensation, Legion
Helmsman Management Services, Inc.	7/1/93	Workers' Compensation	Mission Insurance, Western Employers
	8/16/93	Automobile	National Colonial
Cambridge	11/19/02	Workers' Compensation	Fremont, Reliance, Legion/Villanova
Private Adjusting Claims Services (PACS)	9/26/00	Workers' Compensation	Alister, Superior, Cal Compensation
Intercare Insurance Services	1/10/01	Workers' Compensation	Credit General Insurance Company, Legion, Reliance, Paula, Superior, Cal Compensation, Western Growers, Great States, HIH
Tristar Risk Management	9/26/00	Workers' Compensation	Superior, Cal Compensation, Legion
Risk Enterprise Management, Ltd.	9/26/00	Workers' Compensation	Reliance
Keenan & Associates	11/12/01	Workers' Compensation	Reliance, Phico
LWP	11/20/02	Workers' Compensation	Legion

On some of the large liability files ($100,000 or greater), the Association maintains a “shadow” file in-house while leaving the actual file at the TPA. The Association also maintains a large number of high-exposure workers’ compensation claims in-house. However, due to the high volume of claims that have been, and continue to be presented to the Association, only selected catastrophic claims are brought in-house. The decision of which claims are to be brought in-house is made by the Association in consultation with managers at the TPA. The files that remain with the various TPAs are overseen by the Association’s field management teams.

The Association has an ongoing audit program in place to monitor and control the policies and procedures that its TPAs must adhere to. In addition to monitoring TPAs from its home office, the Association placed compliance representatives on site at the four largest TPA locations. These compliance representatives also remotely monitor other TPAs under contract.

Monthly meetings between the Association’s claims managers and each TPA are held to discuss large losses. The TPAs also provide the Association with quarterly status reports. The Association has access to the claims systems servicing the majority of the workers’ compensation claims and periodic reports are generated to determine the trending for the average cost of closed claims. Monthly audit sheets (summarized by TPA location) are prepared which compare individual TPA’s results to industry standards.

Submission for review and approval by the Association representatives is required in a variety of circumstances including denied claims, settlements greater than specified amounts, reserve changes greater than specified amounts, and Compromise and Releases.

TERRITORY AND PLAN OF OPERATION

Insurance companies writing property and casualty insurance business in California are required to participate in the California Insurance Guarantee Association. If an admitted property and casualty insurance company becomes insolvent, the Association administers unpaid claims and assesses each property and casualty insurance company up to 2% for all lines of written premium in the appropriate category. California Insurance Code (CIC) Section 1063.145 requires all property and casualty insurance companies to surcharge policies to recover these assessments.

The Association has the responsibility to pay and discharge covered claims of insurers as of the date California declares the property and casualty insurance company insolvent and a liquidator is appointed. Covered claims primarily include the policy obligations of insolvent insurers arising from property and liability coverages (exclusive of those lines not included per CIC Section 1063.1).

The Association allocates its claim payments and costs, incurred or estimated to be incurred, to one or more of the following categories: (a) workers' compensation claims; (b) homeowners' claims, and automobile claims, which include: automobile material damage, automobile liability (both personal injury and death and property damage), medical payments and uninsured motorist claims; and (c) claims other than workers' compensation, homeowners', and automobile. Separate premium charges (assessments) are required for each category. The premium charges for each category are used to pay the claims and costs allocated to that category.

The CIC and labor laws establish the maximum claim settlement amounts for workers' compensation claims. Claims settlement amounts for covered claims other than workers' compensation are limited to $500,000 per claim or the policy limits, whichever is lower.

When a property and casualty insurance company becomes insolvent, the control of its assets transfers to the state insurance liquidator in its domiciliary state. The liquidator uses the assets of the insolvent insurance company to settle the outstanding liabilities of the company. Liquidators may advance funds to the Association prior to the settlement of all outstanding debts. The Association recognizes these advances as revenue when received. The advances are utilized to discharge claims against the insolvent insurance companies. The respective liquidator can recall these advances, in whole or in part. The Association recognizes any recall of advances when notified by the respective liquidator or receiver.

To the extent that assets, including advances from liquidators, are insufficient to discharge claim obligations, additional premium charges are assessed member insurers when determined necessary by the Board of Governors (Board) of the Association. Conversely, to the extent that the assets exceed the ultimate cost of claim obligations for insolvent insurers, the excess fund balance, if any, will be applied to reduce future premium charges by the Association in the appropriate category.

Premium charges are accrued as of the date declared by the Board of the Association and become due from the member insurers when billed. The rate of premium charges to each member is initially based on the written premium shown on the latest year's annual financial statement on file with the California Insurance Commissioner. The premium charged to any member insurer by the Association shall not be more than 2% until December 31, 2007, and thereafter shall not be more than 1% per year.

In the event of a natural disaster, the Association, to the extent it determines necessary or desirable, may request the California Department of Insurance (CDI) to issue bonds pursuant to Article 14.25 (commencing with CIC Section 1063.50) to provide funds to pay covered claims of insolvent insurers. The Association may act as agent of the CDI to collect premium payments levied by the CDI on its member insurers.

Additionally, CIC section 1063.70 authorizes the Association to request the issuance of bonds by the California Infrastructure and Economic Development Bank to more expeditiously and effectively provide for the payment of covered claims that arise as of result of the insolvencies of insurance companies providing workers compensation insurance. Proceeds for the sale of bonds shall be deposited into a separate account of the Workers' Compensation Bond Fund. Notwithstanding any other limits on assessments, the Association shall have authority to levy upon member insurers special bond assessments in the amount necessary to pay the principal of and interest on the bonds. Any bonds issued to provide funds on covered claim obligations for workers' compensation claims shall be issued prior to January 1, 2007 in an aggregate principal amount outstanding at any one time not to exceed $1.5 billion. As of June 30, 2005 there were $750 million in bonds outstanding.

The Association is required to adopt a plan of operation. The plan of operation and any amendments thereto are subject to prior written approval by the Commissioner. On November 17, 2005, the Association filed an amendment to strengthen the indemnity provisions in favor of the Governors. On April 11, 2006, the California Insurance Commissioner authorized the changes proposed by the Association.

As of June 30, 2005, the Association is providing insolvency insurance for one hundred and twenty (120) insolvencies, including both active and inactive companies. The Association is currently spending approximately $59 million a month in benefits and administrative costs for 55,000 open claims.

Effective September 29, 2005, the Governor of California signed Assembly Bill 817 (AB817). AB817, which amends the California Insurance Code governing the operations of the Association, expands the definition of covered claims to include the obligations of an insolvent insurer to indemnify a permissible self-insured employer for its liability to pay workers' compensation benefits. However, these claims are not considered workers' compensation claims and therefore are subject to the per claim limit of $500,000. Estimates of the total liabilities for these additional covered claims as a result of AB817 are not yet available.

REINSURANCE

Reinsurance, entered into by insurers prior to their insolvencies, is administered by the California Department of Insurance, Conservation and Liquidation Office (CLO), and is therefore excluded from the Association's financial statements. Reinsurance recoveries made by the CLO may be advanced to the Association subject to the priority needs of the estate in liquidation. Ancillary liquidations may also have a demand on assets recoverable including reinsurance recoverable.

ACCOUNTS AND RECORDS

The financial statements presented by the Association, which are regularly audited by independent certified public accountants, are prepared on a Generally Accepted Accounting Principles (GAAP) basis with a June 30th fiscal year. The Association's financial statements are prepared on a conservative basis (i.e., full value of estimated California-risk reserves are established with no deduction for inuring reinsurance recoverables, no anticipation of advances from estates in liquidation, and advances are recorded only when received).

FINANCIAL STATEMENTS

. The Association's financial statements included in this examination include the following:

Statement of Financial Condition as of June 30, 2005

Statement of Income and Changes in Surplus Funds
for the Fiscal Year Ended June 30, 2005

Statement of Cash Flows for the Fiscal Year Ended June 30, 2005

Statement of Financial Condition
as of June 30, 2005

Assets		June 30, 2005 Per Examination	Notes
Cash and short-term investments			
Unrestricted		$ 164,643,000	
Restricted for workers' compensation claims		69,907,535	
Investments in debt securities available-for-sale, at fair value			
Unrestricted		842,920,111	
Restricted for workers' compensation claims		326,245,375	
Accrued investment income		5,745,391	
Premium charges receivable		177,375,987	
Unamortized bond issue costs		6,098,748	
Fixed assets		4,463,843	
Deposits and other assets		9,648,801	
Total assets		$ 1,607,048,791	
Liabilities and Surplus Funds			
Reserves for claims and claims adjustment and administrative expenses		$ 3,827,371,315	(1)
Reserve for excess liquidator advances		16,735,859	(2)
Reserve for unearned premiums		42,918,000	
Assessments returns due to members		20,905,893	
Bonds payable		779,619,219	(3)
Accrued interest expense		5,309,857	
Accounts payable		3,869,269	
Total liabilities		$ 4,696,729,412	
Surplus funds:			
Fund balance	$(3,086,715,015)		
Accumulated other comprehensive income	(2,965,606)		
Total surplus funds		(3,089,680,621)	
Total liabilities and surplus funds		$ 1,607,048,791	

Statement of Income and Changes in Surplus Funds
for the Fiscal Year ended June 30, 2005

		Fiscal Year Ended June 30, 2005
Assessments and investment activity:		
Premium charges declared		$ 455,157,257
Provision for uncollectible premium charges		(494,978)
Net investment income		31,200,087
Net realized investment gains (losses)		(2,791,957)
Liquidator activity:		
Advances from liquidators		92,408,550
Decrease in reserve for excess liquidator advances		21,041,365
Total Income		596,520,324
Claims activity:		
Claims paid	$ (540,792,266)	
Claim adjustment expenses paid	(134,489,216)	
Decrease in reserve for claims and claim adjustment expense	447,370,914	
		(227,910,568)
Policy unearned premium activity:		
Policy unearned premiums paid	$ (11,710,603)	
Decrease in reserve for unearned premiums	10,130,000	
		(1,580,603)
Administrative expense activity:		
Administrative expenses paid	$ (25,723,734)	
Interest expense	(19,329,869)	
Decrease in reserve for administrative expenses	654,000	
		(44,399,603)
Total Expenses		(273,890,774)
Net income		322,629,550
Accumulated other comprehensive income		(837,012)
Surplus funds at beginning of period		(3,411,473,159)
Surplus funds at end of period		$ (3,089,680,621)

Statement of Cash Flows
for the Fiscal Year Ended June 30, 2005

		Fiscal Year Ended June 30, 2005
Cash flows from operating activities:		
Net income		$ 322,629,550
Adjustments to reconcile net income to net cash provided		
By operating activities:		
Depreciation and amortization	$ (1,869,331)	
Decrease (increase) in:		
Premium charges due from members	$ 58,585,720	
Allowance for uncollectible premium charges	(359,000)	
Accrued investment income	(516,854)	
Other assets	2,776,090	
Total		58,616,625
Increase (decrease) in:		
Reserve for claims, claim adjustment and administrative expenses	$ (448,024,914)	
Reserve for excess liquidator advances	(21,041,365)	
Reserves for policy unearned premiums	(10,130,000)	
Assessment returns due to members	(9,185,107)	
Accrued interest expense	5,309,857	
Accounts payable	3,199,111	
Loss on sale of investments, net	2,791,957	
Total		(477,080,461)
Net cash provided by operating activities		(95,834,286)
Cash flows from investing activities:		
Debt securities available-for-sale:		
Purchases	$(1,188,580,131)	
Proceeds from sales	809,090,003	
Proceeds from calls or maturities	190,172,138	
Purchase of investments restricted fro workers' compensation claims	(1,031,978,375)	
Proceeds from sale of investments restricted for workers' compensation claims	256,638,482	
Proceeds from calls or maturities, restricted for workers' compensation claims	447,915,518	
Purchase of fixed assets	(2,890,967)	
Net cash provided by investing activities		(519,633,332)

Statement of Cash Flows
for the Fiscal Year Ended June 30, 2005

(Continued)

Cash flows from financing activities:		
Proceeds from bond issuance, net	$ 774,828,483	
Net cash provided by financing activities		774,828,483
Increase (decrease) in cash and short-term investments		159,360,865
Cash and short-term investments at beginning of period		75,189,670
Cash and short-term investments at end of period		$ 234,550,535

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Reserves for Claims and Claims Adjustment Expenses and Administrative Expenses

The Association's reserves for claims and claims adjustment expenses are primarily comprised of workers' compensation reserves associated with recent insolvencies. The Association's workers' compensation reserves are 90% of its total stated reserves.

The Association provided the examiners a draft actuarial report issued by Dale F. Ogden and Associates, (Ogden) prepared as of June 30, 2005. The Association also furnished the examiners a draft report prepared by Milliman, Inc. (Milliman) in which Milliman reviewed the methodology contained in the Ogden report.

The following table depicts the loss and allocated loss adjustment expense (ALAE) reserve estimates of each of these reports contrasted with that reported by the Association.

	(000's omitted)
Loss and ALAE Reserves	Reserve Estimates June 30, 2005
Association	$3,772,443
Ogden	4,664,194
Milliman	2,938,442

According to the Association, Mr. Ogden was retained to perform a limited scope review for the primary purpose of reviewing the adequacy of the Association's reserves as related to the cash flow projections relevant to the bond issue and payment of workers' compensation claims. Mr. Ogden was not engaged to perform a statutory actuarial review or opine on the reserves.

The Association indicated that an actuarial opinion on the total reserves, including bulk and incurred but not reported (IBNR) reserves, is difficult for many reasons including (1) the Association only has the current case reserves and the cumulative loss and loss adjustment expense payments starting from the various liquidation dates at which it began paying the claims of each estate; (2) lack of historical earned premium data and inception-to-date paid losses and allocated loss adjustment expenses; (3) companies differ significantly in the strength of their loss reserves; and (4) claims data available to the Association is usually limited to that which is contained in the claim file.

The examiners requested on several occasions that the Association provide final versions of each of the actuarial reports noted above. However, according to the Association, final versions were never issued.

In addition, the examiners were unable to reconcile the loss and loss adjustment expense data provided by the Association to the data contained in the Ogden report. The Association prepared (at the examiners' request) a detailed claims report to support the summary data utilized to prepare the financial statements. The reports were tested, on a sample basis, by the examiners. In the majority of the claims sampled, the outstanding case reserve and/or the paid amounts did not reconcile to the claim files. According to the Association, the inability to reconcile the detailed claims report data to the claim files was due to the inability of its claims system to provide backward-looking snapshot data at the point in time of the examination (June 30, 2005) since it is a real-time system that is constantly being updated.

The examiners also attempted to reconcile the paid claim amounts reported by the Association for the fiscal years 2004 and 2005 with that reported in the Ogden report. There were also large discrepancies in this data. According to the Association, the Ogden report utilized Association data as well as data from the Workers' Compensation Insurance Rating Bureau (WCIRB). In addition, the Ogden report only utilized specific data for nine of the larger insolvencies to derive data for the other insolvencies at the Association. Thus, the limitations on the Association caused by the lack of historical data and the limited number of insolvencies used make it impossible to reconcile the data.

An actuarial review by the California Department of Insurance of the reserves and related cash-flows was not completed due to the inability to reconcile and verify the underlying data.

It is recommended that the Association obtain an actuarial opinion on the workers' compensation reserves as of June 30, 2006, and on a go-forward basis, that includes a reconciliation of the underlying data and a claim payout analysis which should be utilized in the cash flow projections. In response to this and other related recommendations, the Association will perform a more complete actuarial analysis as of June 30, 2006. In addition, the Association will institute procedures to reconcile the underlying actuarial data to the extent possible given the limitations previously noted.

The Association established a $54,928,000 reserve for adjusting and other expenses (previously known as unallocated loss adjustment expenses) in the above captioned liability account. This reserve represents the Association's estimate of the cost to process all open claims (and any unknown claims that have been incurred but not reported to the Association) and does not include defense and cost containment expenses (previously known as allocated loss adjustment expenses), which is included in its claims adjustment expense reserves. This reserve is formula-driven for each line of business and represents approximately 2.8% of the Association's reserves for claims.

According to the Association, differences in liquidation basis accounting and the need for it to be responsive to the demands of liquidators in many states make it difficult to determine the ultimate costs of the administration of claims handled by the Association. The Association believes the estimate established is a reasonable reserve estimate since it is based on historical payment data for administration expenses from inception to date.

Based on the information provided by the Association, the examiners were unable to determine the reasonableness of these reserves. It is recommended that the Association prepare detailed documentation to support the source of the information along with written narratives that discuss the methodology used to establish these reserves. In response to this recommendation, the Association provided the California Department of Insurance documentation supporting its reserving process for adjusting and other (unallocated) expenses.

(2) Reserve for Excess Liquidator Advances

The captioned liability represents the Association's provision for recall of excess liquidator advances received. As the Association is unable to determine the extent or timing of this potential recall, a reserve equal to the surplus fund balance of the respective insolvencies is established.

(3) Bonds Payable

On September 30, 2003, the Governor of the State of California signed Assembly Bill 227 (AB227). AB227 enables the Association to issue up to $1.5 billion in bonds through the California Infrastructure and Economic Development Bank. The proceeds of these bonds will be used to pay and discharge workers' compensation claims.

On August 18, 2004, the Association issued $400 million in fixed rate and $350 million in variable rate Workers' Compensation Relief Bonds. Net proceeds from the issuance of the bonds were approximately $774.8 million.

At June 30, 2005, the carrying value of the bonds was $779.6 million. The fair value of the Association's bonds is estimated based on quoted market prices and reporting date for similar bonds.

The long-term debt of the Associaton is collateralized by the special bond assessments that are paid to the Association under California Insurance Code Section 1063.74.

(4) Cash Flow Analysis

The examiners reviewed the Association's five-year cash flow projections. The cash flow projections were prepared without the benefit of a projected payout analysis developed by an actuary. Although the Association's cash flow projections prepared as of June 2004 appear reasonable, it should be noted that the Association is currently operating in a very dynamic environment and many events known and unknown can materially affect the actual cash flows of the Association's workers' compensation fund.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Summary of Significant Findings - Cash Flow Projections: (Page 3): It is recommended that the Association obtain a full and comprehensive actuarial analysis for the purpose of estimating future workers' compensation claims payments in the preparation of its cash flow analysis.

Management and Control – Conflict of Interest (Page 6): It is recommended that the Association provide written conflict of interest disclosure forms to be signed by employees on an annual basis. The recommendation was also noted in the previous examination. In response to this recommendation, the Association will (beginning in 2006) provide written conflict of interest agreements to be signed by management staff on an annual basis.

Reserve for claims and claim adjustment expenses and administrative expenses (Page 17): It is recommended that the Association obtain an actuarial opinion on the workers' compensation reserves as of June 30, 2006, and on a go-forward basis, that includes a reconciliation of the underlying data and a claim payout analysis which should be utilized in the cash flow projections. In response to this and other related recommendations, the Association will perform a more complete actuarial analysis as of June 30, 2006. In addition, the Association will institute procedures to reconcile the underlying actuarial data to the extent possible given the limitations noted in this report.

It is also recommended that the Association prepare detailed documentation to support the source of the information along with written narratives that discuss the methodology used to establish these reserves. In response to this recommendation, the Association provided the California Department of Insurance documentation supporting its reserving process for adjusting and other (unallocated) expenses.

Previous Report of Examination

Management and Control – Conflict of Interest (Page 9): It was recommended that the Association provide written conflict of interest disclosure forms. In response to this recommendation, the Association will (beginning in 2006) provide written conflict of interest agreements to be signed by management staff on an annual basis.

Officers', Employees', and Agents' Welfare and Pension Plans (Page 12): The Association provided general benefit and employee salary ranges but, although requested, declined to provide specific management salary and contract information, citing confidentiality concerns. In the course of the current examination the Association only provided salary information on a summary basis.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Association's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Constance J. Korte, CFE
Examiner-In-Charge
Department of Insurance
State of California